



U.S.A.ID/ PADCO SOCIAL SECTOR REFORM PROGRAM

THE REGULATION OF NON-STATE PENSION SYSTEMS

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1. THE IMPORTANCE OF PRIVATE PENSION SYSTEMS

Private pension systems are very important. Regardless of whether they are mandatory or voluntary, they offer a safe – and usually privileged – way for people to ensure a higher standard of living after retirement than is possible if retirees must rely on solidarity systems alone. But they also serve a larger purpose: they provide a source of long-term capital that can be profitably invested in economic development. In countries such as the United Kingdom, the Netherlands, and Switzerland, private pension systems have grown so that the total value of pension investments exceeds one half of GDP (see Table 1). With the exception of Germany and Japan – two countries facing problems with their state pension systems and with their private capital markets – pension funds are a major part of annual net savings.

Table 1
Pension Funds as a Source of Capital in Selected Countries

<i>Country</i>	<i>Pension Assets as % of Personal Assets</i>	<i>Pension assets as % of GDP</i>	<i>Annual Increase in Pension Assets as % of Annual Personal Savings</i>
United Kingdom	27.2	57.0	71.3
United States	13.2	33.8	49.9
Canada	14.1	26.7	38.8
Japan	2.1	4.6	19.5
Germany	2.4	3.5	3.9
Netherlands	39.6	77.9	37.9
Switzerland	-	68	95.0

Source: E. P. Davis, *The Structure, Regulation, and Performance of Pension Funds in Nine Industrial Countries*, The World Bank, Policy Research Working Paper 1229, 1994.

But to serve these purposes effectively, private pension funds must be properly regulated. Failure to regulate funds properly inevitably leads to financial disasters that not only eliminate personal savings but also destabilize emerging capital markets. From The Czech Republic to The Russian Federation, there are many painful examples of what happens when regulators either lack experience, power or information, or have been corrupted by fund managers to allow improper investments. Since the public regards the Government as the ultimate guardian of the pension system – public or private – the collapse of a private fund usually requires the government to step in and compensate those who have lost money. If governments provide substantial tax deductions or credits to encourage private pension savings, or if it mandates participation in private pension plans, then they have the responsibility to ensure this money is managed with care.

This paper summarizes the important issues that Ukraine must consider when designing the regulatory system that will oversee its mandatory or voluntary non-state pension system.

2. THE DANGERS FROM NOT REGULATING PRIVATE PENSIONS

Pension funds are a tempting source of capital to investors. Without an efficient and honest system of regulation, fund managers may be tempted to use the money they manage in unwise, or even dishonest, ways

– with little chance of discovery for many years. There are several reasons why pension funds must be regulated:

- Understanding and assessing the soundness of pension funds are beyond the knowledge and skills of the average worker. So the government must act as a representative of the interests of the general public, and bring together the necessary expertise and resources to effectively monitor pension savings.
- Enterprises or the state government may be tempted to regard pension funds as a cheap source of investment, and attempt to create pension funds that are nothing more than a conduit from contributors to the enterprise or to finance the government deficit;
- Pension fund managers may be tempted to invest pension fund proceeds in their own enterprises or in the enterprises of friends rather than in safer investments;
- Because pension funds do not have to pay out benefits for many years, losses due to deliberate fraud or poor investments will not show up for many years – thus protecting crooks and incompetents from exposure.

3. OBJECTIVES OF PENSION REGULATION

Given that governments are responsible for regulating and supervising private pension funds, what should be the objectives of pension regulation and supervision?

1. To Ensure the Integrity and Safety of the Private Pension Industry
 - ✓ To ensure pension participants are adequately informed
 - ✓ To maintain a high degree of public confidence in the system
 - ✓ To ensure stability in the pension industry
 - ✓ To ensure pension savings are actually used for providing retirement income
 - ✓ To prevent or eliminate conflict of interests
 - ✓ To avoid concentration of financial power
 - ✓ To ensure tax deductions for pension contributions are legitimate.
2. To Limit the Amount of Risk Taken With Investments of Pension Funds
 - ✓ To protect pension contributions from loss
 - ✓ To ensure pension contributions are invested at attractive rate of returns
 - ✓ To limit the amount of investment risk
 - ✓ To ensure reliable valuation of pension assets
3. To Deal with Problems that Do Occur Quickly and Efficiently to Prevent Them From Spreading Throughout The Pension Fund Industry
 - ✓ To detect problem pension funds and minimize losses of pension participants
 - ✓ To ensure orderly liquidation of insolvent pension funds

4. PRINCIPLES OF PENSION REGULATION AND SUPERVISION

To be effective, pension supervisory authorities must conform to certain basic principles.

4.1 *Don't Rely on Only a Single Regulatory Agency to Oversee All Aspects of the Industry*

Most countries outside Latin America have chosen to use multiple regulatory agencies to oversee pension funds. This is because different regulatory agencies have historically been involved with regulating different aspects of the system – the National Bank is responsible for regulating banks, the Ministry of Labor and Social Policy is responsible for labor relations issues, and the Securities Commission is responsible for capital markets. With all these institutions already in place, many countries have chosen to build on existing agencies rather than creating an entirely new structure. In the USA – whose regulatory system is represented graphically below – different agencies regulate different aspects of private pensions. Some examples of the different types of regulation and oversight in the United States include:

- New private pension funds must register with two agencies. The Department of Labor ensures that the plan is fair to participants and does not favor a certain type of beneficiary. The Internal Revenue Service (the equivalent of the State Tax Administration) ensures that the new fund meets the rules to gain advantage of tax benefits.
- Annual financial statements of pension funds must be examined by independent auditors. All public corporations are required to hire an independent auditor to audit their financial statements. Copies of the audit are submitted to all shareholders as well as to tax authorities. Since the failure to properly investigate financial statements may result in the auditors being liable for any later losses, they conduct these audits carefully.
- The investment activities of the pension fund are regulated by the Department of Labor.– The Ministry of Labor establishes general fiduciary guidelines which must be followed by pension funds. These include the “prudent expert” standard, and guidelines for diversification, risk management, avoidance of conflict of interest, and rules regarding prohibited transactions.
- The capital markets are regulated by the Securities and Exchange Commission (SEC)
- Defined benefit pension plans are insured against insolvency – to certain limits – by the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a quasi-governmental organization which collects premiums from pension fund sponsors, and pays benefits to beneficiaries in the event of pension fund bankruptcy. Their activities apply only to defined benefit pension plans. No such insurance is provided for accumulation systems.
- All the legal entities in which the pension fund invests are also subject to detailed oversight. Banks, insurance companies, investment companies and other entities that manage pension fund investments are subject to strict accounting and investment regulation by different regulatory agencies.

This diversity of regulation and oversight minimizes the chance that regulators will become “captive” of the pension funds industry they regulate.

4.2 *Create a Transparent Regulatory System*

Pension funds must know and understand the objectives of the regulatory regime and the role of the regulators. Regulators must explain in writing (and their explanations be public record) how they interpret the law and regulations and how they intend to apply the statutory rules in actual practice. This means that regulatory

procedures must be administered in the same way for everyone. For example, the administrators of financial management companies must know why administrators take actions such as suspending licenses or requiring the company to take corrective measures. Prior to such actions, full discussions should have taken place and explicit written warnings issued.

Transparency should also apply to the information available to potential contributors in pension funds. In the USA, the manner in which rates of return are calculated and disclosed are strictly regulated to avoid manipulation. In addition, business magazines and magazines aimed at protecting consumer rights publish information comparing the rates of return and other aspects of private pension plans. They collect their information from audited financial statements that pension funds are required to submit to participants and to regulators. Therefore, customers can choose among private pension plans based on the average rate of return over various time periods, the administrative costs charged by fund managers, the type of investments made by funds (some invest only in government securities, others may invest in a more diversified portfolio) and other factors. Until Ukraine has a well-developed business press, a government regulatory agency could be required to prepare an annual report summarizing basic facts about all licensed pension funds (average rate of return, characteristics of the investment portfolio, administrative costs as a percentage of funds under management, etc).

4.3 Act Quickly and Fairly.

Timeliness applies to both the reviews of all documents submitted by the pension fund as well as to the application of corrective measures. Financial reports and other documents must be reviewed as soon as possible after they are filed. Corrective measures should be applied as soon as necessary. Delays increase risks of further deterioration of a bad situation.

Timeliness ensures that regulators maintain their credibility. Regulators' demands that corrective action be taken promptly will not be taken seriously unless the regulators themselves acted promptly. Pension fund administrators will accept more willingly requests for additional information or for changes to current documents when made soon after documents have been filed.

4.4 Be Objective in Interpreting and Applying the Law and Regulations.

In any emerging country or new industry, it is important for the regulators to set the proper example of fairness, transparency and the necessity for compliance. The initial actions taken by the regulators will establish how seriously the industry takes the law and regulations. It is therefore, very important that from the start, regulators provide competent review of documents, fair application of the law and regulations, and strict periodic supervision of the operation of the pension funds and management companies.

4.5 Give All Companies an Equal Opportunity to Succeed.

It is the regulator's duty to ensure that each qualified enterprise has an equal and fair chance to acquire a license and to do business. This fairness creates what is called "a level playing field" and encourages fair and open competition among enterprises – which is the best way of ensuring that customers have the best possible choices of pension funds in which to invest and that they are likely to earn the best possible rate of return.. It promotes confidence within the industry that they are being dealt with based upon merit and not on some other criteria.

4.6 Listen to All Comments from the Industry and the Public and Change Regulatory Procedures If Appropriate.

To do a good job, regulators must stay informed about industry developments and trends, and assess whether existing regulations are effective and consistent with the objectives of the law. More specifically pension regulators need to know and understand what is actually going on in the pension industry in terms of new trends, risks, and problems. They must know which regulations are effective, which ones are useless or counterproductive. If new products are emerging, regulators need to consider whether new regulations are needed. Sometimes regulations, drafted with the best of intentions, turn out to discourage new investment practices or products that are good for pension participants. A valuable source of information is pension administrators themselves. Therefore, regulators must listen carefully to what the fund administrators say. It is common practice in Western countries to require all regulations in proposed form first. Then everyone is given an opportunity to submit written comments, and public hearings are held to allow the opportunity for oral comments as well. Only after this process are regulations published in final form. Regulators sometimes develop an arrogant attitude toward the companies they regulate and ignore valuable industry comments.

4.7 Be Competent and Professional.

To make difficult and complex decisions involved in granting or refusing licenses, requiring changes in investment practices, and dealing with financial problems of private funds, regulators must be knowledgeable about pension laws and regulations and the rationale behind them. They must also understand the principles and day-to-day operations of pension funds. They must also be independent - free from political or private influences. Otherwise, their credibility and effectiveness will be damaged. Both of these are significant problems in the former Soviet Union. Regulators simply don't have the experience and knowledge to regulate private pension systems. And licensing decisions are often dictated by politicians.

Regulatory agencies, therefore, must adopt strict rules for its staff. Regulators must be free from conflicts of interest, self-dealing, breaches of fiduciary duty, or favoritism. For example, they should not be shareholders of a pension fund or management company. Regulatory staff who discover that members of their families, relatives, or business associates, are shareholders of a pension fund or an asset management company, must be required to disclose the fact in writing to the head of the regulatory agency. The head must then decide whether the conflict is serious. If it is, the employee would be moved another position. The head of the regulatory agency must be subject to the same policy - required to disclose potential conflicts to the appropriate government organization. Failure to disclose a potential conflict of interest - regardless of how serious the conflict found to be -- may lead to employment termination and, if the conflict is found to be serious, may even lead to criminal prosecution.

It is customary, in the USA, for the appointment of heads of regulatory agencies to be approved by the US Congress. Nominees are required to disclose, publicly, all their financial interests and these disclosures are reviewed carefully by the members of Congress. At the same time, to avoid subjecting administrators to political pressure, they cannot be dismissed from their position unless there is evidence that they have violated the law or administrative procedures.

4. DUTIES AND TOOLS OF THE PENSION REGULATORY AUTHORITIES

4.1 DUTIES OF A REGULATORY AGENCY

- Establish procedures for licensing

- Grant/suspend/peel licenses
- Monitor statutory filings
- Review financial reports and other statutory filings
- Follow-up on unsatisfactory filings
- Perform on-site audits
- Require corrective measures when necessary
- Respond to inquiries
- Amend current regulations
- Identify industry trends and draft and propose new regulations
- Communicate and consult with the industry
- Inform and advise the government on pension fund issues.

4.2 SUPERVISORY TOOLS

To perform their duties effectively the regulators need to develop a set of specific tools:

- Informational data bases: Statistics gathered from financial statements and other required findings should be maintained and published
- Communication mechanisms: The regulators should have regular means of communicating with the industry. This includes different types of published regulations, regular hearings, conferences, web sites, and informational publications on different topics
- Review and audit checklists and procedures: Audits should be done in a systematic and consistent fashion. To do this, standardized checklists and procedures must be established for employees of the regulatory agency.
- On-site examination procedures and methodologies: Again, procedures must be standardized and consisted for each audit. There should be a standardized report prepared from each audit. And the results of the audit must be communicated to the company, along with a list of any corrective actions required
- Early warning and risk assessment systems: The types of financial information requested, and the internal audit procedures must give information which can be used to assess the probability of a pension fund having future financial trouble. Standardized financial ratios should be calculated and analyzed
- Intervention framework: There must be a standardized set of procedures for intervention. This should involve oral and written warnings, requests for corrective action, follow-up procedures, and civil and criminal proceedings. The exact sequence of steps and requirements should be carefully documented, and should be understood by regulatory staff and the industry.

The basic functions and roles of supervision may be broadly understood in Ukraine. But pension fund regulatory expertise is totally absent. This can only be acquired by years of experience, and is a major impediment to the development of a safe private pension system in Ukraine. The involvement of outside experts in the day-to-day activities of the regulator will help to accelerate the learning process. The structure of the regulatory system has also not been established, and the full array of regulatory tools, and the regulations

to support them have not yet been developed. In addition, proper accounting standards are not yet in place, nor are on-site audit procedures. So a great deal of work is required before the regulatory system is ready for the very serious responsibility of assuring a level playing field, and protecting the interests of plan participants.

CHARACTERISTICS OF PRIVATE PENSION PLANS IN THE USA

TYPE OF PROGRAM	CHARACTERISTICS
<p>Employer Sponsored Pension Trusts</p>	<ul style="list-style-type: none"> • Voluntary (employer decides whether to offer plan – self-employed are treated as employers). • 45% of all workers covered nationwide. • Part-time workers who work less than 1,000 hours per year need not be covered, and up to 30% of all employees may be excluded. • Up to 5 years of work before employee “owns” pension. • Plans may offer defined benefits or defined contributions: <ul style="list-style-type: none"> ✓ Defined benefit plans are insured by the Pension Benefits Guaranty Corporation ✓ Defined contribution plans are like individual savings accounts but with strict limitations on when owners can withdraw money • Contributions, up to a maximum level, are exempt from income taxation • There are strict funding rules for defined benefit plans, which generally require pensions to be fully funded prior an individual’s retirement.
<p>Individual Savings</p>	<p>All individuals may save up to \$2,000 per year exempt from income taxation in qualified savings account.</p> <p>Money cannot be withdrawn without penalty until individual is 59 ½ years old</p> <p>.</p> <p>Interest earned is not subject to taxation until money is withdrawn.</p>

REGULATORY SYSTEM FOR PRIVATE PENSION PLANS IN THE USA

(Federal Regulatory agencies shown in shaded boxes)

